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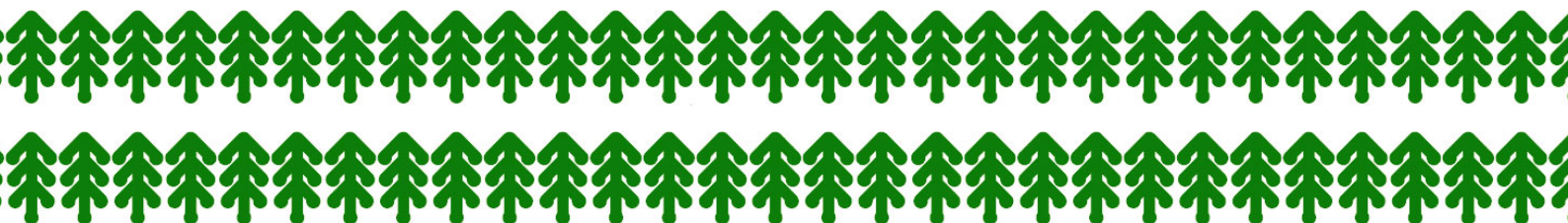
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# Improvements to the New Zealand Emissions Trading Scheme

Discussion Paper No: ME 1380

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Contents

Introduction.....	3
Summary.....	3
Our Submission.....	7

## Introduction

1. This submission has been prepared by the New Zealand Forest Owners Association Inc (FOA) on behalf of its members.
2. FOA is the representative membership body for the commercial plantation forest growing industry. FOA members are responsible for the management of approximately 1.2 million hectares of New Zealand's 1.7 million hectares of plantation forests and over 70% of the annual harvest.
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## Summary

The FOA considers that the ETS has been stalled in a number of areas for several years. It is important to move forward urgently on a transition path with emissions including an immediate commitment to a minimum level of reduction and a signal of further intent.

Forestry offers a temporary solution to help the transition to a low carbon economy but should not be a substitute for taking strong action to reduce emissions and change behaviours.

FOA has previously provided feedback on the option of auctioning. This approach has been under consideration for several years. While in principle it can work effectively and is used elsewhere, success is critically dependent on the auctioneer being transparent about the mechanics, settings and future objectives. Done correctly this can provide increased stability, certainty and liquidity. Done incorrectly the ETS will be dysfunctional.

The other reason for ensuring a strong focus is maintained on cutting emissions elsewhere is that increased afforestation will not necessarily equate to increased ETS participation, and increased ETS participation will not necessarily mean units will be available in the market. The degree to which forest owners actively supply the ETS market will depend on what they consider the opportunity cost of having a deforestation liability attached to their land is. Where the alternative land use options are low the relative cost of active participation is also low and vice versa.

FOA supports the existing requirement for an overall NZU limit and limitations on the maximum amount of units that can be auctioned each year but notes that even with that a high degree of uncertainty still remains. The broad range of factors to be taken into account when setting limitations still leaves considerable uncertainty about what the final levels will be. The Zero Carbon Bill and the role of the Independent Climate Change Commission are the latest factors that add to this uncertainty. We also have significant concerns about any system that allows

government to introduce an unspecified level of additional units to the system. This effectively creates a hidden price cap.

Related to this we note that the document states that there is no consultation being undertaken on the critical issue of unit supply volumes until the components above have been progressed. This will be particularly important if international units are introduced to the system and/or any “other” units are envisaged.

The forward trajectory on price should be as transparent as possible and heavily determined by an independent advisory body – The Climate Change Commission. There are many variables listed in the consultation document that are relevant for such a body to take into consideration. The list presented appears more than comprehensive enough to cover implications and influences that could arise. As the document notes, however, it is also important to provide regulatory predictability.

The fixed price cap has already been exceeded by the market price and a replacement signal is urgently needed. Any replacement needs to allow the price to continue to increase in a controlled way that maintains liquidity.

We also endorse the recognition of the important role of the secondary market and being cognisant of the liquidity in that secondary market.

The FOA positions on each of the specific areas being consulted on are as follows:

FOA supports in principle the proposal to set and announce annually NZ ETS unit supply volumes over the consecutive five years as well as incorporating an overall cap on the number of units supplied and having decisions constrained by an independent advisory body. ....	7
FOA considers that the document lacks adequate information for us to be able to support the preferred option. ....	7
FOA supports holding auctions on a quarterly basis. ....	7
FOA supports all NZ ETS account holders being able to participate in an auction. ....	8
The FOA does not have a strong position on whether the revenue from auctioning should be quarantined for specific climate change objectives. ....	8
The FOA considers there is insufficient information available on supply volumes and their origin to conclude that replacing the fixed ceiling price model with a cost-containment reserve model is necessary, or an improvement. ....	8
The FOA considers mandated formulae for determining the price ceiling over time is preferable but impractical but the alternative of having government discretion needs to be strengthened with independent, difficult to change, recommendations. ....	9
The FOA considers that the examples provided may warrant allowing changes to the price ceilings outside of the 5-year process because the adjustment required may otherwise take too long but that with adequate planning, and annual adjustment, these interventions should be minimal and last-resort options. ....	10

FOA considers that the level of international units that could be included in the scheme by allowing non-government purchase of such units will not justify the complexity, cost and role of doing so especially where this is borne by an ETS participant. ....	10
The FOA does not support trying to differentiate between NZ ETS participants based on some assessment of need, or ability to utilise units.....	11
FOA supports an up-front decision on industrial allocation that commits to a specified level of phase out (3%) from 2021 combined with a decision-making process to subsequently modify this after 3 years once the decision-making assessment has been completed and if this warrants an adjustment. This balances the need to provide some urgency of emissions reduction with a means of review at the earliest opportunity. ....	11
FOA proposes that the 3% phase out be signalled to commence in 2021 to run until 2030 as proposed in the document but be reviewed after 3 years by the Climate Change Commission.....	12
The FOA notes that a higher phase down rate does not necessarily imply a higher level of units being auctioned, simply a higher level of domestic units available for use. ....	13
FOA is not aware of any areas that have raised serious governance risk concerns to date but does consider the risk will be elevated with the introduction of some of the proposed changes to the ETS.....	13
FOA supports the principle of publishing information on emissions and compliance activity. ....	14
The FOA supports introducing strict liability infringement offences for low-level non-compliance but that also provide time for the infringement to be rectified without penalty. ....	14
FOA supports using a proportional approach where the penalty applied is a percentage value of the outstanding surrender obligation. ....	14
FOA supports limiting new units where there are overdue obligations but, for forestry at least, supports the approach proposed in the document “A Better ETS for Forestry” of netting new entitlements off against overdue obligations and does not agree with the conclusion in this document that such an approach is too complex.....	15
FOA does not have a preferred position on whether large purchasers of coal or natural gas can take some, rather than all, of a supplier’s obligations unless this flexibility adds significant cost for all ETS participants in which case it is opposed .....	15
FOA supports closing the loophole related to coal stockpiling.....	15
FOA supports the government being able to amend “unique emissions factor errors” from previous years consistent with other ETS legislation.....	16
FOA supports providing the flexibility for participants to repay the same type of unit received from the Crown rather than the current inflexible requirement that it be the exact units received. ....	16
FOA supports introducing a specified time period for repayment of units where annual allocation adjustments require this but proposes that for forestry a 60-day period (rather than 30 days) be applied to make it consistent with s.189 as discussed in the next section.....	16

FOA supports amending the deadline for surrenders and repayments to be 60 days from the date a notice is sent by the regulator, rather than from when a return is submitted by the participant.16

FOA supports allowing consolidated groups to apply for an industrial emissions allocation to avoid the need for corporates to hold multiple accounts. ....16

FOA supports providing clarification that an ETS account holder’s representative can close the account. ....16

FOA also supports that (unlike under the Companies Act) the ETS account operators can continue to operate the account until a succession plan is in place on the basis that without this the account would be closed and any residual units would go to the Crown.....16

The potential need for alignment with the other schemes is acknowledged and supported.

## Our Submission

### 2. New Zealand Emissions Trading Scheme unit supply framework

#### 2.2 Co-ordinating unit supply decisions

FOA supports in principle the proposal to set and announce annually NZ ETS unit supply volumes over the consecutive five years as well as incorporating an overall cap on the number of units supplied and having decisions constrained by an independent advisory body.

As well as the requirement to provide one year's notice of changes to unit supply volume, we contend that the NZ ETS decision-makers should be heavily influenced by the Independent Climate Change Commission which will also be weighing up multiple factors. We also submit that the ETS decision-makers should provide an expected supply trajectory for out years even if this is subject to annual review and confirmation.

#### 2.3 Auctioning

##### 2.3 (1) Format: Auction bidding format and pricing design

FOA considers that the document lacks adequate information for us to be able to support the preferred option.

The analysis presented in the auctioning options available is very limited although we consider this choice is less important than whether an auction system is used.

Within reason it is important to reduce complexity and cost and to develop a system that does not favour particular participants.

FOA agrees that the spot market can also provide an important valuable means of price information and therefore assist with bidding, although price discovery has been challenging to date with a limited spread in the market.

FOA does have concerns about the ability of a few large bidders to collude more easily in multiple round auctions. Similarly, the concerns over the relative ability to read and influence the market by some, and the tendency for discriminatory pricing to result in bids below true value, suggests that uniform pricing where all successful bidders pay the same clearing price is preferable.

On the basis of the analysis provided in the document the scaled bid, single round auction with uniform pricing appears preferable, but we consider that half a page of limited comments with no information on how the summary impacts have been arrived at is not a sufficient basis to come to a conclusion. This issue has been investigated for several years and more detailed analysis was warranted.

##### 2.3 (2) Frequency: How often the government holds auctions?

FOA supports holding auctions on a quarterly basis.

We agree that weekly auctions are too frequent and annual auctions not frequent enough. The impact on the secondary market is important. On balance, it is considered that a reasonable

period of time should be allowed to let the secondary market play its role. Quarterly auctions do not seem to be of such a duration that disruptive volume levels would have accumulated.

### 2.3 (3) Who is able to participate in an auction?

FOA supports all NZ ETS account holders being able to participate in an auction.

Depth and arbitrage are important elements of robust functioning markets. Concerns about behaviour can be addressed to an extent through the eligibility criteria yet to be developed. The cost to the scheme, and participants, of attempting to limit participants to a subset also seems unwarranted. The lowered risk of collusion is also a factor in allowing a broader auctioning population.

### 2.3 (4) Use of proceeds from auctioning

The FOA does not have a strong position on whether the revenue from auctioning should be quarantined for specific climate change objectives.

We acknowledge the importance of maintaining national funding flexibility but consider there are arguments why the auction funds should be earmarked to go to purposes that support the objectives of the ETS.

Such targeted funding will ensure the ETS is being supplemented by other mechanisms and allow the transition to a fully functional all sectors, all gases, ETS at a quicker pace than would otherwise be the case. It could also be important for investor confidence in the pricing setting.

## 2.4 Price Ceiling

The FOA considers there is insufficient information available on supply volumes and their origin to conclude that replacing the fixed ceiling price model with a cost-containment reserve model is necessary, or an improvement.

Since the consultation document was released the price of NZUs on the market has reached the fixed ceiling price (\$25). While this can only be accessed by participants who have a surrender obligation to meet, it will still add to the supply of units in the market and that includes forest owners (both post-1989 who elect to exit from the ETS and pre-1990). This sets up a new unintended dynamic in the market place and this will become an increasing issue from this point forward. The cost of meeting emitters obligations is now shifting to the Crown. Certainty around price has increased at the cost of certainty around emissions. We effectively have a carbon tax.

Maintaining a fixed ceiling price with no clear stated intention of where it is expected to be in the future is also at odds with the objective of the ETS.

A third option available to government, and which should not yet be rejected, is to let the market determine the price. The option of allowing a market price to prevail is dismissed on the basis that prices might become unacceptably high and require the government to intervene and this would damage the credibility and integrity of the scheme. If demand reached a level where the price was “acceptable” then whatever mechanism the government is using to mask that market signal will raise questions about the integrity of the scheme and that applies to the proposed cost containment reserve. The FOA notes also that the New Zealand electricity spot market price is not capped, yet most Energy Intensive Trade Exposed industries (EITEs) participate and price spikes prompt behaviour change.

A significantly increased fixed price, such as the \$75 level recommended by the Productivity Commissioner, would still allow the market to operate while providing a signal of where the government point of intervention lay.

In principle the proposed cost containment reserve might do the job but in principle so can a ceiling price. Whether it is a superior mechanism in achieving our climate emission goals or simply adds complexity, will be determined by what price level triggers intervention (just as now) the increase in that over time (currently zero) and the number of units allowed in to the reserve (just as the current model was influenced by international units). All information we do not have.

In that sense the preferred option here is contingent on what options are chosen in the subsequent sections.

The most significant concern with a cost-containment reserve is that no indication is provided in the document about what units will be contained in the reserve. Notably, the ability for the government to print units is not ruled out. This concern can be mitigated, but not removed, by committing to a specified price increase trajectory and having the decision on intervention determined by an independent body.

### **Managing the Price Ceiling Over Time.**

The FOA considers mandated formulae for determining the price ceiling over time is preferable but impractical but the alternative of having government discretion needs to be strengthened with independent, difficult to change, recommendations.

Whilst a price setting mechanism that was formulaic and entirely predictable helps address concerns about certainty and predictability, such an approach is unlikely to be politically acceptable and we do not believe it would be sufficient a high stress test anyway and would result in continual tinkering with the formula. The Reserve Bank process of setting the interest rates relies on qualitative and quantitative data but the importance of stability and certainty in that decision-making process is recognised as being paramount. If the decision-maker is government then the advice to the decision-maker needs to be independent and hard to deviate from.

## Dealing with Special Circumstances

The FOA considers that the examples provided may warrant allowing changes to the price ceilings outside of the 5-year process because the adjustment required may otherwise take too long but that with adequate planning, and annual adjustment, these interventions should be minimal and last-resort options.

The FOA acknowledge that special circumstance may arise that need to be accommodated in the rules, but we do not consider the price ceiling being struck as one of those. Linkage to another carbon market may require additional rules but these should also be predictable.

The key point is that the system should be able to be designed to avoid disruptions that are foreseeable to ensure confidence in, and commitment to, the system.

## 2.5 Limiting the Use of International Units

### 2.5 (1) Mode of purchase of international units

FOA considers that the level of international units that could be included in the scheme by allowing non-government purchase of such units will not justify the complexity, cost and role if doing so especially where this is borne by an ETS participant.

In general, the FOA supports the principle of allowing both direct and indirect acquisition of international units. This could allow some businesses to access channels and some opportunities that the government might otherwise not utilise. We anticipate the task of meeting New Zealand's Nationally Determined Commitment will require a significant reliance on international units and thus utilising the collective power of government and private enterprises in accessing them appears, at face value, to be logical.

Multiple access, however, needs to be weighed up against the cost and complexity of managing multiple streams of units particularly when the government will still almost certainly procure the vast majority of the units and individual firms will almost certainly access more, or less, than their allocated quota, and many will likely be zero.

The net impact on the number of units in circulation will be zero because government will adjust its contribution accordingly to maintain the 5-year announced limit, but it will be more complex to track non-standard units and government will also need to monitor and control the quality of the international units.

On balance FOA considers that the level of international units that could be included in the scheme by allowing non-government purchase of such units will not justify the added complexity and cost of making this option available and would not support revenue from auctioning being used to cover any net cost of allowing this. We further anticipate that the government has already secured significant volumes of international units knowing that these will be needed. This also reduces the need to rely on private sector participants supplementing supply particularly when they are unlikely to have made similar provision given that their ability to use such units was not confirmed.

Even if direct participant trading of international units is permitted on a limited scale we question whether this has to result in such units being in circulation. The document states that indirect purchase would be simpler as only NZUs would be in circulation. The government has the ability to acquire the international units from private participants. This does not reduce complexity but NZUs could be the only unit currently within the scheme under either model.

The concerns raised in the document about reductions being unrealised to removal efforts and unit flows from various sectors being harder to predict are shared by FOA and add to the conclusion that the overall benefit of allowing non- government participation will be outweighed by the costs.

This is also a consideration for government if considering linking with other schemes if those schemes do allow use of international units.

## **2.5 (2) How will the overall volume of international unit surrender rights allowed be distributed between ETS participants?**

The FOA does not support trying to differentiate between NZ ETS participants based on some assessment of need, or ability to utilise units.

The ETS is complex enough. Allowing direct participation will bring significant complexity and, as noted, we do not consider this will be justified. To add to that complexity by trying to operate a system that then creates classes of direct participants is something that should not be contemplated.

We are very clear on one aspect. If international options are made available, then these should be made available uniformly. The document acknowledges that “windfall” profits unrelated to emission removal efforts are a risk with any direct participation but then suggests that forestry participants or those receiving industrial allocation of NZU’s might have a different percentage allocation because of this. This is not consistent.

We further contend that if international units are allowed in to the system there is no justification for preventing NZU’s to be allowed out of the system into the international marketplace. There are parallels here with free-trade principles.

## **2.6 A phase-down of industrial allocation**

FOA supports an up-front decision on industrial allocation that commits to a specified level of phase out (3%) from 2021 combined with a decision-making process to subsequently modify this after 3 years once the decision-making assessment has been completed and if this warrants an adjustment. This balances the need to provide some urgency of emissions reduction with a means of review at the earliest opportunity.

The comments in the consultation document about the age of the data that is being used as the basis for current EITE allocation is well made. It is important for both EITE participants and other ETS participants that the trajectory of the phase out of allocation is signalled. The current “on-hold” position is not sustainable and undermines the ability of the ETS to change emitter behaviour, something that, to date, the ETS has failed to do.

A number of “broad approaches” are presented in the paper as potential solutions to the current situation and there is an acknowledgment in the document “select all that apply” that these approaches are not mutually exclusive.

The FOA consider that an up-front decision that commits to a specified low-level of phase out should commence from 2021. This provides a strong signal of commitment that will influence investment decisions, including the effort committed to mitigation measures but can be set at a level that provides a “background “conservative transition away from emissions intensity that avoids leakage. We consider that this can be supplemented with on-going assessment to then signal, within an appropriate notification period, how much in excess of the minimum background commitment the level will actually be set and/or to recalibrate the 2021-reduction trajectory.

The Climate Change Commission will inevitably need to undertake similar considerations related to ETS settings and would seem ideally suited to provide independent recommendations on the rate of phase-down and any differentiation between industrial allocation activity types.

The range of factors to take in to account do support incorporating a decision-making advisory body with capacity to assess these.

As noted in the document though, a decision-making process may not deliver decision-making in the near term and thus relying on this as the only approach risks continued uncertainty and fiscal exposure for the Crown.

### **The impact of different phase-down rates.**

FOA proposes that the 3% phase out be signalled to commence in 2021 to run until 2030 as proposed in the document but be reviewed after 3 years by the Climate Change Commission.

As noted, it is now 8 years since the phase out rate was expected to commence at 1% per year and this is provided for in legislation. A rate of 3% beginning in 2021 would then be implementing a phase-down 11 years after it was originally intended. This emphasises the importance of moving early and gradually with reductions. Postponing does not send the required signal for behavioural change and results in eventual over-steep phase out trajectories.

A 3% phase out introduced in 2021 will almost have caught up to a 1% phase (initiated in 2010) by 2026. On the basis that an early announcement can be supplemented with the other assessment approaches proposed in the consultation documents, we consider that an up-front minimum conservative commitment to 3% is made in tandem with a commitment to use a modified decision-making process that can inform that commitment further after 3 years (by 2024). This provides some ability to catch-up in a measured way.

### Impacts on carbon budget

The FOA notes that a higher phase down rate does not necessarily imply a higher level of units being auctioned, simply a higher level of domestic units available for use.

A higher phase down rate will make more units available and these would be available for auction. Critically, however, this does not imply they will be used for auctioning. They could, for example, just mean less reliance on international units which would be logical as they would be reflecting progress in reducing emissions domestically.

## Operational issues

### 3.2 Market governance

FOA is not aware of any areas that have raised serious governance risk concerns to date but does consider the risk will be elevated with the introduction of some of the proposed changes to the ETS.

FOA recognises the need to maintain adequate governance arrangements to keep market participants informed and protected. As noted, there is a broad range of participants with varying circumstances. A one sized approach is unlikely to be the answer.

From the forestry sector's experience, we are not aware of any significant issues where participants have suffered from any of the risks listed. There will always be an onus on any participant to accept a degree of responsibility in ensuring they are adequately informed about any decision they are taking. With respect to advice, the NZ Institute of Forestry maintains a list of registered forestry consultants with the objective of maintaining ethical behaviours and current professional competency.

The consultation document rightly observes that wholesale changes to market government requirements can have unintended consequences. The FOA would be particularly concerned about the unintended consequences, for example, of re-categorising NZUs as financial instruments. The associated compliance costs could easily result in the level of expertise available diminish to a select number of providers and the cost be sufficiently prohibitive to owners of smaller forests that their ability to access quality advice is made worse.

We acknowledge, however, that further substantive changes to the ETS are pending and support the intention of government to give further consideration to this important area.

### 3.3 Market information

FOA supports the principle of publishing information on emissions and compliance activity.

A fully informed market is a better functioning market. Publishing individual emission data could allow other emitters to better gauge where they sit with respect to emissions reductions.

Publishing details of non-compliance could be important for participants who may be potential transactors with non-compliers, but such publication should be restricted to deliberate non-compliance examples.

### 3.4 Compliance and penalties

FOA agrees that the integrity of the ETS is impacted by compliance behaviour, adjustments are needed and that prosecutions for low level offences are not appropriate.

Where there is little or no penalty for non-compliance this will result in some participants paying inadequate regard to meeting their requirements. The NZ ETS review has clearly identified areas for improvement.

#### **Tools to manage low-level offending (Infringement offences).**

The FOA supports introducing strict liability infringement offences for low-level non-compliance but that also provide time for the infringement to be rectified without penalty.

Introducing strict liability offences would be consistent with other environmental legislation. Some measure to encourage compliance is warranted and this system allows the person served with the notice to contest or rectify. That said we believe the system should act as a deterrent and not be a revenue-generating approach. FOA considers that infringement notices could put participants on notice of the infringement and notify them of the timetable by which penalties will apply (much like an abatement notice under the RMA) but that they should only be levied where compliances are not achieved within the grace period.

We also note (in table 17, page 83) that a non-compliance incident previously considered “reasonable” would become eligible to incur a penalty. FOA does not consider there is justification to move those instances of non-compliance where there is acceptable reason to a position where in the future they will face a penalty regardless.

#### **Options for changing the excess emission penalty for failing to surrender or replay units.**

FOA supports using a proportional approach where the penalty applied is a percentage value of the outstanding surrender obligation.

The Inland Revenue model that is cited in the consultation document is a relevant comparison and recognises that the impact and cost of non-compliance is related to the magnitude of the non-compliance about which it can also be argued that all levels of non-compliance will entail a minimum level of extra follow-up work for the enforcement agency.

Under this option it is assumed that the agency ability to reduce the penalty depending on circumstances is retained. If it is not, then the fixed dollar value penalty should be applied.

A third option is to set the fixed dollar value penalty in relation to the price of carbon over a period of time noting that this was low when it was originally set and the significant movement in the price since then.

### 3.5 Technical and operational improvements

#### Issue 1 – Receiving units where there are overdue obligations

FOA supports limiting new units where there are overdue obligations but, for forestry at least, supports the approach proposed in the document “A Better ETS for Forestry” of netting new entitlements off against overdue obligations and does not agree with the conclusion in this document that such an approach is too complex.

FOA accepts that no participant should be receiving additional units while there are outstanding liabilities that have not been met.

We do not agree that it is too difficult for credits to be netted off against liabilities and the document provides no basis for reaching the conclusion that it would “*unnecessarily complicate reporting and emissions data*”.

Forestry data needs to accommodate changes on a regular basis and the system has shown that it is able to accommodate that to date. Indeed, this document is inconsistent with the other consultation document – “A Better ETS for Forestry” which concludes just the opposite i.e. that a net approach offers the best solution to the problem.

Such an approach allows the administrator to make an immediate adjustment that deals with outstanding payments and is supported by FOA.

#### Issue 2 – Partial opt-in

FOA does not have a preferred position on whether large purchasers of coal or natural gas can take some, rather than all, of a supplier’s obligations unless this flexibility adds significant cost for all ETS participants in which case it is opposed

FOA is in general support of providing flexibility but questions whether relieving a supplier of only some of their obligations materially improves the efficiency of the ETS and justifies the cost of maintaining the machinery to track this.

#### Issue 3 – Closing a loophole related to coal stockpiles in all coal activities

FOA supports closing the loophole related to coal stockpiling

We agree this undermines the integrity of the ETS and is counter to its objectives and should therefore be stopped.

#### **Issue 4 – Ability to amend unique emissions factor errors from previous years**

FOA supports the government being able to amend “unique emissions factor errors” from previous years consistent with other ETS legislation

#### **Issue 5 – Repayments for Industrial Allocation (s125) and Forestry (s189)**

FOA supports providing the flexibility for participants to repay the same type of unit received from the Crown rather than the current inflexible requirement that it be the exact units received.

The important point is the obligation is discharged without cost to the Crown and with similarly credible units.

#### **Issue 6 – Annual allocation adjustment repayment**

FOA supports introducing a specified time period for repayment of units where annual allocation adjustments require this but proposes that for forestry a 60-day period (rather than 30 days) be applied to make it consistent with s.189 as discussed in the next section.

Having no specified period for submitting payments to “true-up” annual adjustments was clearly an oversight, and a time period should be specified. There appears to be no compelling reason why it should differ from the time period that applies to other repayments for participants.

Forestry repayments are covered by s.189 as below.

#### **Issue 7 – Surrenders and repayment under s.189 (post-1989 forestry)**

FOA supports amending the deadline for surrenders and repayments to be 60 days from the date a notice is sent by the regulator, rather than from when a return is submitted by the participant.

The time period of 60 days was intended to give the participant adequate time. Including an unknown period taken by the regulator to process the emissions return is clearly not reasonable or intended and the proposed solution addresses this.

#### **Issue 8 – Allowing consolidated groups to apply for an industrial allocation**

FOA supports allowing consolidated groups to apply for an industrial emissions allocation to avoid the need for corporates to hold multiple accounts.

#### **Issue 9 – Inconsistencies with the Companies Act 1993**

FOA supports providing clarification that an ETS account holder’s representative can close the account.

FOA also supports that (unlike under the Companies Act) the ETS account operators can continue to operate the account until a succession plan is in place on the basis that without this the account would be closed and any residual units would go to the Crown.